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Investment Age

DOL rejects Polaroid ploy

Trustee told to override ESOP rule

By Joel Chernoff

WASHINGTON — The Department of Labor has sent a warning shot across the bow of the trustee of Polaroid Corp.'s ESOP on its duties in a tender offer situation, but the trustee apparently won't heave to.

In a position that may limit the appeal of employee stock ownership plans as part of a corporate defense against a hostile takeover, the Labor Department wrote in a Feb. 23 letter to Citizens & Southern Trust Co., Atlanta, the Polaroid ESOP trustee, that the trustee must override the terms of Polaroid's ESOP and exercise its own judgment on whether to tender shares unallocated to participants and shares where participants have not directed the trustee.

Whether the trust, which holds 14% of Polaroid common stock, tenders its shares might be a key factor in whether hostile bidder Shamrock Holdings Inc., Burbank, Calif., is successful in its $45-a-share offer. Shamrock is the investment vehicle for Roy E. Disney.

In Delaware, where Polaroid is incorporated, a hostile bidder must obtain at least 85% of the target's stock or wait three years until it realizes the benefits of the merger.

Of the 9.7 million shares held by the ESOP, 90% are unallocated to participants,

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The S&P 500 isn't what it once was

By Marlene Givant Star

NEW YORK — The Standard & Poor's 500 Stock Index, the equity benchmark most widely used by institutional investors, has become a moving target thanks to the rash of corporate restructurings during the past five years.

Indeed, 24.2% of the companies that were in the index on Jan. 1, 1984, have disappeared. Those 121 companies represented 14% of the 1984 S&P market value, according to a recent study by Tom Doerflinger and Michael Geraghty of PaineWebber Inc., New York.

Sixteen of the replacement companies also have vanished.

"The S&P 500 of January 1984 would be the S&P 379 on Oct. 31, 1988," according to an IDS Advisory Group Inc. investment policy statement commenting on the study.

Because of the restructuring wave, the S&P contains many more growth stocks than five years ago, meaning active managers are competing against a more growth-oriented index. For index fund managers, the dynamic nature of the index has made passive investing less a buy-and-hold strategy than a buy-tender-buy strategy, the PaineWebber report said.

What's more, the high turnover tends to raise transaction costs — not only in terms of commissions but also because the costs of replacement stocks typically rise significantly once their inclusion in the index is announced.

"It's just hard to replace an RJR (Nabisco Inc.) or Gulf Oil (Co.)," said Douglas T. Holmes, a vice president in charge of domestic equity management at State Street Bank and Trust Co., Boston. "There have been more changes in the S&P than we suspect people realize there are."

Keeping up with the changes in the index is frustrating because a stock's opening price is at least 5% higher following the announcement of its inclusion in the S&P. State Street prefers to

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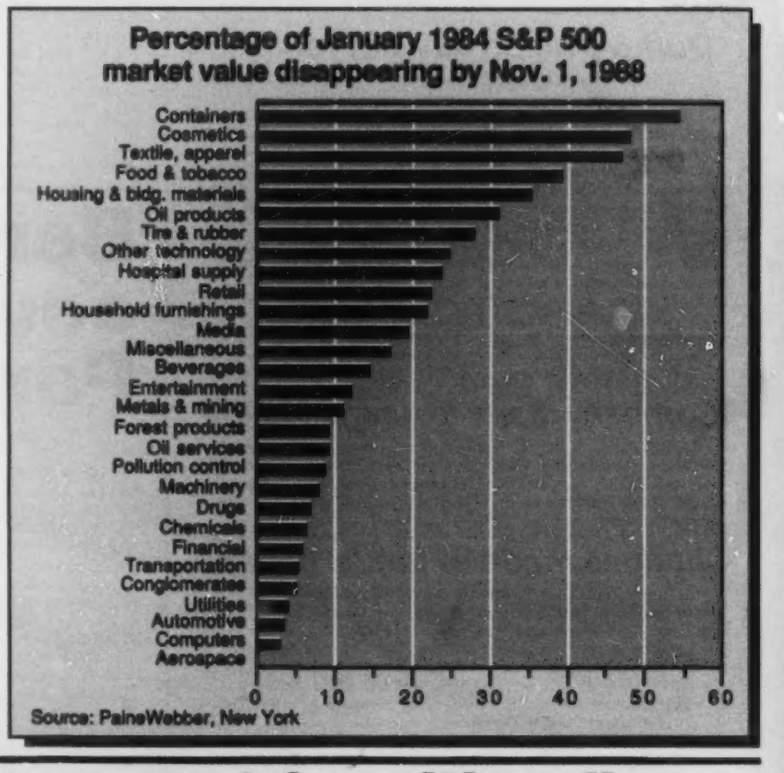

Firms investing in distressed companies*

Company	$ millions
Morgens, Waterfall, Vintiadis	350
Neuberger and Berman	250
Recovery Equity Partners	150
Oppenheimer	145
The Foothill Group	130
T. Rowe Price	107
Trust Co. of the West	100
Pacholder Associates	100
Amroc Investments	60
Whitman Heffernan Rhein	60
Halcyon Investments	25
Calhoun, Meehan & Co.	15

*Numbers represent amounts raised or targeted

$1.5 billion targeted for ailing firms

By Marcia Parker
and Marlene Givant Star

Fueled by a surge in institutional capital, commitments to distressed company investments soon could reach $1.5 billion if the new limited partnership funds in the market meet their targets.

So far, institutional investors have pumped more than $500 million into limited partnerships that invest in financially ailing or bankrupt companies. The targets of funds still being marketed account for the remaining $1 billion. The money will be invested during the next two years.

Investors are attracted by lucrative returns — an average of 40% to 50% — in a still unexploited area and the view that there will be an even more abundant supply of product in the event of an economic downturn.

The investors include corporate pension funds such as Warner-Lambert Co., Morris Plains, N.J., and Dayton Hudson Corp., Minneapolis; endowments and foundations such as The Rockefeller Foundation, New York; insurance companies, including Monumental Corp., Baltimore; and a smattering of public pension funds. Cash-rich utilities also are newcomers. In addition, Oppenheimer & Co., New York, is marketing the first fund targeted solely at foreign institutions.

"We thought returns would be very favorable. It's relatively new to plan sponsor avenues of investment. We wanted to be one of the first in the area," said Marc Shapiro, director-pension investments at Warner-Lambert.

"We want to get in before there's too much money chasing too few deals" like the leveraged buy-out and venture capital areas, he said.

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LATE NEWS

Guidelines set in Texaco review

NEW YORK — In a precedent-setting agreement, Texaco Inc. accepted a decision by its equity committee to give Salomon Brothers Inc. a statement of principles to guide the investment bank in rendering a fairness opinion on the shareholder rights proposal Texaco is expected to unveil soon.

This is the first time a shareholder group, corporate executives and an investment bank have agreed to a set of guidelines for an investment bank in performing a specific assignment.

Salomon Brothers was hired by the equity committee to evaluate the company's proposal that must be submitted to a shareholder vote at the annual meeting in May.

Salomon Brothers agreed to evaluate any proposed rights plan "from the viewpoint of its fairness to common stockholders generally who hold their shares for investment purposes and do not participate in the management of Texaco or seek to obtain control of Texaco." Salomon also will take into consideration "more than the direct financial benefit conferred upon stockholders of the rights plan."

Advisers' proxy policies lacking

WASHINGTON — A Department of Labor study found many money managers fail to clearly establish who has responsibility for voting corporate proxies and numerous managers fail to keep accurate records of their proxy votes and policies.

In an anxiously awaited study to be released this week, the Labor Department sent a warning that private pension funds and money managers had better clean up their act.

The study found 61% of the 111 managers responding had voting responsibilities. Of those managers, 47% did not have specific voting authority but had assumed that role when the plan and investment documents were silent.

Duff & Phelps buy-out realized

CHICAGO — With a large part of the financing coming from some 10 pension funds and $65 million in junk bonds, Freeman Spogli & Co. and top management completed the $146.2 million leveraged buy-out of Duff & Phelps Inc.

The group paid $128.5 million to Duff & Phelps' employee stock ownership plan, the sole stockholder. The other $17.7 million went for other expenses, including fees, associated with the leveraged buy-out.

FS Equity Partners II L.P., of which Freeman Spogli, a Los Angeles-based merchant bank, is general partner, and 75 Duff & Phelps management executives put up $21.4 million and $8.6 million respectively in equity for the purchase, according to Bradford H. Freeman, Freeman Spogli partner, and Francis E. Jeffries, Duff & Phelps president. The remainder came from the 15%, 10-year subordinated notes sold by Merrill Lynch Capital Markets Inc., New York, and a $51.2 million commercial bank loan syndicated by Bankers Trust Co., New York, said Mr. Freeman.

Company starts leveraged ESOP

CLEVELAND — Parker Hannifin Corp. plans to borrow up to $70 million to establish a leveraged employee stock ownership plan. The ESOP shares will match employee contributions to the company's 401(k) plan, which has assets of $158 million, a spokesman said.

Changes made in funds' lineups

- LOS ANGELES — The $8 billion Los Angeles County Retirement Association selected Merus Capital Management Inc., San Francisco, to run a $60 million equity portfolio emphasizing stock yields. Also, Robert Hermann has been named chairman of the county retirement board.
- DALLAS — Electronic Data Systems Corp. hired Northern Trust Co., Chicago, as master trustee of the company's $214 million pension fund, according to Douglas Crow, assistant treasurer.
- BRADENTON, Fla. — Tropicana Products Inc. has selected Bankers Trust Co.'s Global Fiduciary Services Group as trustee for the company's 401(k) plan, which has about $9 million.

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Questionnaires overdue

The deadline to return questionnaires for the 1989 Investment Adviser issue has passed. If you have not returned your questionnaire, but wish to be included in the directory, please contact Christine Philip, directory coordinator, at *Pensions & Investment Age*, 740 N. Rush St., Chicago, Ill. 60611-2590; (312) 649-5217.

Few caught off guard by interest rate hike

By Barry B. Burr and Curtis Vosti

Corporate executives and money managers predict the Federal Reserve Board will raise interest rates further, but few will make major changes in their investment portfolios as a result.

Many of those interviewed in a *Pensions & Investment Age* telephone survey agreed with the action Federal Reserve Chairman Alan Greenspan has taken to try to quell inflation fears, saying they had expected the Fed's moves.

"I think he's timing it correctly," said Jeffrey Meyer, financial analyst-pensions for the $292 million San Diego Gas & Electric Co. pension fund.

"A lot of people say it's too late, or not harsh enough," he added. "I think his gradual movements are more appropriate. Overall, I feel pretty comfortable."

"If anything, (Mr. Greenspan) has been a little slow to raise rates," said James W. Doucette, vice president-investment management at Humana Inc., Louisville, Ky.

The Fed raised the discount rate for loans it makes to banks to 7% from 6.5%, the highest rate since early 1986. The Feb. 24 move pushed the federal funds rate banks charge on loans to each other to 9.75% from 9.25%, widely influencing other interest rates.

H. Kent Atkins of Bankers Trust believes interest rates are heading much higher.

Market rates already have been climbing and showing the effects of an inverting yield curve. The yield to maturity on a 10-year Treasury bond was 9.27% March 1, compared with 8.15% a year earlier. For a 27-year Treasury bond, the yield was 9.16% up from 8.4%.

The Consumer Price Index has been climbing as well, rising in January 0.6%, or an annualized 7.2%, from a year ago, according to the latest statistics.

H. Kent Atkins, chief investment officer for the Bankers Trust Co. — Investment Management Group, New York, which manages $52.8 billion in tax-exempt assets, said, "The discount rate hike has been anticipated since November. The Fed is picking its way very carefully along this minefield, rather than charging way ahead.

"We forecast that rates are going higher, quite a bit higher before peaking perhaps later this year."

As a result, Mr. Atkins said, corporate debt service will increase.

"There's a lot of variable debt out there," he said. "Higher rates lead to lower price-earnings ratios which limits the outlook for stock and bond market appreciation. Our current position is pretty cautious."

In its balanced portfolios, Bankers Trust is 50% in stocks and 30% in cash. Equity portfolios have 20% cash.

Mr. Doucette said Humana's

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Benefits ruling could turn into Pandora's box

By Joel Chernoff

WASHINGTON — A U.S. Supreme Court decision might spawn a host of litigation over whether employers properly grant benefits under retirement and welfare plans.

In a Feb. 21 ruling criticized for its murkiness, the high court held a plan administrator's denial of severance benefits is not entitled to special deference by a court.

That unanimous decision, in Firestone Tire & Rubber Co. vs. Bruch, threw out the previously accepted standard that an employee must show a plan administrator's decision to deny benefits was "arbitrary and capricious."

But Justice Sandra Day O'Connor's opinion then carved out a broad exception to the "de novo" standard the court had just established: She wrote the new standard applies "unless the benefit plan gives the administrator or fiduciary discretionary authority to determine eligibility for benefits or to construe the terms of the plan."

"That exception could gobble up the rule," said Gary Ford, a partner in the law firm of Groom and Nordberg Chartered, Washington, and who recently resigned as general counsel of the Pension Benefit Guaranty Corp.

It remains unclear to some pension lawyers whether delegating authority to plan administrators would return the plan to the "arbitrary and capricious" standard, or to some other standard.

Complicating matters further, Justice O'Connor then noted an exception to the exception. Citing trust law, she explained, "Of course, if a benefit plan gives discretion to an administrator or fiduciary who is operating under a conflict of interest, that conflict must be weighed as a 'factor in determining whether there is an abuse of discretion.' "

Experts criticized this sentence as being unclear, and some experts worried lower courts might come to varying and perhaps erroneous conclusions as to the high court's intent.

"I think that's kind of a wild card, as to how the lower courts are going to apply that," said Henry Rose, a partner in the law firm of Epstein Becker & Green, Washington.

Steve Sacher, a shareholder in the law firm of Johnson & Swanson, Washington, agreed, saying courts probably will look at such conflicts "somewhere in between 'arbitrary and capricious' and 'de novo.' "

The case involved the late 1980 sale by Firestone of its plastics division to Occidental Petroleum Co. Most of the 500 salaried employees involved were rehired by Occidental. But six employees who had been rehired sought severance benefits from Firestone under their severance-pay plan.

At the time, Firestone was not aware the plan was subject to the 1974 Employee Retirement Income Security Act and had not set up a claims procedure or met the law's reporting and disclosure requirements.

Saying the sale of the plastics unit was not a "reduction in work force" under the plan and the employees no longer were plan participants, Firestone denied the benefits claims.

A U.S. District Court ruled in favor of Firestone, saying the company's decision was not arbi-

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Windfall from RJR not idle?

By Andrea Rothbard

Pension funds [illegible] in RJR Nabisco Inc. are putting their profits into index funds or other stocks they consider to be takeover targets, now that Kohlberg Kravis Roberts & Co.'s record-breaking $25 billion leveraged buy-out of RJR has closed.

Many of the windfalls — as much as $87.4 million in the case of the $87.14 billion Teachers Insurance and Annuity Association College Retirement Equities Fund, New York — will be rolled back into the Standard & Poor's 500 index fund that owned the RJR stock.

But James Stevenson, investment director of the $18.4 billion State of Wisconsin Investment Board, Madison, said profits from the fund's 185,000 RJR Nabisco shares were also invested in other takeover stocks, which he declined to identify. "It was reinvested in stocks we hope will be another RJR," he said.

Lee Jansson, director of equities for the $16.4 billion Florida State Board of Administration, Tallahassee, said the fund's profit from RJR Nabisco stock was invested in stocks "we think are undervalued."

BICs get new respect

FDIC says it will cover bank contracts

By Fred Williams

WASHINGTON — The Federal Deposit Insurance Corp. removed a major obstacle to increased bank participation in the $150 billion guaranteed investment market by issuing a legal opinion claiming bank investment contracts from three major issuers are covered by FDIC insurance provisions.

The FDIC determination on bank investment contracts issued by Bankers Trust Co., Manufacturers Hanover Trust Co., both in New York, and Washington Mutual Savings Bank, Seattle, is a major setback to the insurance industry's long-standing claim that BICs are not subject to FDIC coverage.

The three banks are the most active participants in the BIC market. The determination, however, is being interpreted as extending to BICs issued by all banks.

According to a letter from the FDIC legal division, signed by attorney Faye L. Ferguson, the three BICs meet the FDIC's statutory definition of a deposit and "would be afforded FDIC insurance coverage" of up to $100,000 per participant.

The FDIC previously had been vague on whether BICs were covered by the bank insurance program. This led the insurance industry, which has enjoyed a virtual monopoly in the guaranteed investment marketplace through guaranteed investment contracts, to claim BICs were not covered.

Insurance company executives, however, remain skeptical and are contemplating a legislative effort through the American Council of Life Insurance Companies to confront the FDIC insurance issue with regard to BICs. The council has formed a special task force to study the BIC issue.

When asked about the group's efforts, Steve Kraus, a specialist in the council's tax division, said, "We're not particularly anxious for everyone to know what we are going to do."

The FDIC letter, which is similar to a revenue ruling from the Internal Revenue Service, "puts to rest finally any question anyone has whether BICs are a deposit subject to FDIC insurance," said Hubert Forcier, partner with the Minneapolis law firm of Faegre & Benson and special counsel to Washington Mutual Savings Bank.

"Now that you have a clear statement from the FDIC, there is no real-world chance any change in the FDIC regulations could become retroactive," he said.

Steve Katsanos, a spokesman for the FDIC, confirmed the content of the letter. "The bottom line is that it is a deposit and banks will pay a premium (to the FDIC) on it. If these are being represented as a deposit, we have an exposure and should be getting insurance premiums," he said.

Mr. Forcier, and other sources, pointed out the insurance industry's argument will be made more difficult because "this is the first time (the FDIC) has said a BIC is a deposit."

Mr. Kraus said the insurance council has filed a letter with the FDIC opposing the agency's proposed regulation expanding the definition of deposits to include most general-obligation debt issued by member banks.

"Our experience is that this investment is risky and the FDIC is not fully aware of the risks," he said. "The (council) doesn't say that (BICs) aren't covered. We are only saying that it is inappropriate to cover them. We agree they are covered. We are not going to take the position that banks don't belong in the pension business selling BICs. All we want is a level playing field, and right now we think banks have an unfair advantage."

Michael Boyen, a GIC consultant with Wyatt Asset Services, Portland, Ore., said the FDIC determination is "extremely important."

Mr. Boyen said the FDIC insurance coverage is only one of several layers of protection afforded investors.

The primary factor in reviewing BIC issuers is credit analysis of the bank or "whether or not they will be whole."

An added layer of protection is whether, in the event of a bank failure, another bank acquires the failed bank — the usual course when banks fail.

Money center banks may offer even more protection. "Would the FDIC let a money center bank go under? If the government wouldn't let Continental Illinois (National Bank and Trust Co. of Chicago) go under, it is unlikely any others would be allowed to," he said.

"With insurance companies, all you have is the first level (overall credit quality). If an insurance company goes under, they can't fall under Chapter 11 (of the Federal Bankruptcy Code), they fall under the various state laws in the states where they are located," he said.

While Mr. Boyen said the letter clarifies the issue of whether FDIC insurance covers BICs, the cost of the insurance will increase. Banks now pay eight basis points annually to the FDIC in premiums based on assets.

A spokesman for Nationwide Insurance Co., Columbus, Ohio, said the issue of FDIC insurance for BICs remains questionable.

"We wonder about it. . . . I have concluded that the FDIC insurance is a legitimate thing. But we take the position that there is not the expertise (in the banking industry) in covering the risks," he said.

"The insurance industry makes use of actuaries in determining risks associated with these commitments, and that's not there with banks," he said.

Frank Gillis, a vice president with Southwestern Life Insurance Co., Dallas, said the use of FDIC insurance for BICs distorts the original intent of the bank insurance program.

"I don't believe the original intention of FDIC insurance was to cover this type of vehicle.

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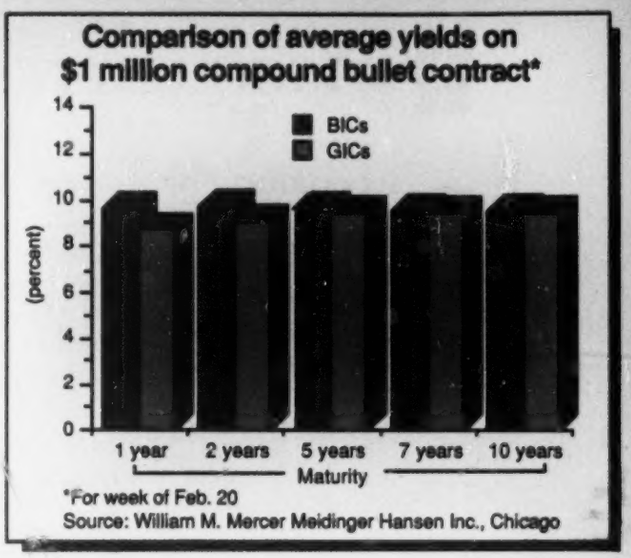

Differences among allocators/timers

Firm	Asset classes used	Factors used	Typical move (%)	Frequency of moves
Aetna	model: stocks/bonds/cash add judgment for real estate int'l, small-cap	forecasted returns & volatility	5	5 - 8 a year
Avatar	stocks/cash stocks/bonds/cash	liquidity, momentum, yield curve, value, deflation	5 - 10	5 - 7 a year
J.H. Ayres	stocks/cash	Federal Reserve monetary policy	100	2 in past 5 years
Bankers Trust	stocks/bonds/cash	monetary, value, sentiment, inflation	5	18 a year
Boston Co.	stocks/bonds/cash	economic, value, technical, sentiment	5 - 30	twice monthly
Chancellor Capital Mgmt.	stocks/bonds/cash stocks/cash bonds/cash	monetary value, sentiment	10 - 20	11 a year
Consistent Asset Mgmt.	bonds/cash	price trends	50 - 100	twice monthly
Davis, Weaver & Mendel	stocks/bonds/cash stocks/cash bonds/cash	price trends, momentum	12.5	4 times a year
First Chicago Investment	stocks/bonds/cash/ int'l/real estate/ venture capital	value, economic	5	10 in past 7 years
First Quadrant	stocks/bonds/cash/ int'l	value, macroeconomic, sentiment	5 - 10	average 2 a month
Hoisington Investment Mgmt.	bonds/cash	economic	100	2 in past 6 years
Matrix Capital Mgmt.	stocks/bonds/cash advisory on int'l	use existing economic factors to forecast returns	10 - 20	monthly
Mellon Capital Mgmt.	stocks/bonds/cash	value	20	NA
J.P. Morgan Investment Mgmt.	stocks/bonds/cash	value, duration	3 - 5	depends on market
NCNB Texas	stocks/bonds/cash	value	15	10 in past 10 years
Northern Investment Mgmt.	stocks/bonds/cash	value	5 - 10	1 - 4 a year
Prudential Diversified Investment	stocks/bonds/cash/ int'l/real estate	value, economic	2	weekly
Renaissance Investment Mgmt.	stocks/bonds/cash bonds/cash	value	50 - 100	average 1 every 9 mos.
M.D. Sass	stocks/bonds/cash	value, economic	5 - 25	7 in past 2 years
Schield Mgmt.	stocks/cash bonds/cash stocks/bonds/cash	price trends, momentum, monetary	100	2.5 a year
TSA Capital Mgmt.	stocks/bonds/cash	value, economic, sentiment	10 - 15	depends on market
Webster Capital Mgmt.	stocks/bonds/cash stocks/cash	value - expected return	5 -10 s/b/c: 25 s/c	monthly
Wells Fargo Investment Advisors	stocks/bonds/cash/ int'l in some accounts	value	20	5 - 7 a year

Borders between timing, TAA hazy

By Trudy Ring

"Is a puzzlement," said the King of Siam, and he might well have been talking about distinguishing between tactical asset allocation and market timing.

Making that distinction, and distinguishing among tactical asset allocation firms, is one of the most difficult tasks facing institutional investors trying to select new money managers.

Definitions of the differences among tactical asset allocators, or between allocators and market timers, are as numerous as the firms claiming those designations.

In addition, the firms' differences often are slight, their similarities are numerous and combinations of the strategies are common.

In general, factors used to determine asset classes and allocations likely are the most important distinctions among tactical asset allocators, followed by size and frequency of asset shifts.

Louis Kingsland, senior vice president of Callan Associates Inc., San Francisco, sees the factors used in investment models as the major distinction between and among allocators and timers. He views market timing as a subset of tactical asset allocation.

Market timers tend to make de-

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General counsel of PBGC resigns

By Joel Chernoff

WASHINGTON — Gary Ford, general counsel for the Pension Benefit Guaranty Corp. for the past two years, has left the government to rejoin the Washington law firm of Groom and Nordberg Chartered as a partner.

A successor has not yet been named, although pension lawyers think the agency likely will pick Carol Flowe, who is deputy general counsel.

A PBGC spokeswoman said a decision on a new general counsel would not be made for a couple of weeks. She declined to comment on Ms. Flowe's prospects of getting the job.

The status of the top pension jobs in the Bush administration still is uncertain. Kathleen Utgoff, PBGC executive director, is said to be interested in the assistant secretary post at the Department of Labor now held by David M. Walker.

Mr. Walker is believed to be interested in moving elsewhere in the administration. Pension experts also said Mr. Walker is discussing possible positions with several accounting and legal firms.

Before joining the PBGC, Mr. Ford had been a partner in Groom and Nordberg, a firm that specializes in tax and pension issues. Earlier, he had served a stint as pension counsel on the Senate Labor and Human Resources Committee.

"Gary Ford has done a superb job for the PBGC and he leaves a legacy of important legal decisions and a first-rate legal department," Ms. Utgoff said through a spokeswoman.

Mr. Ford's two years as the PBGC's top lawyer have been dominated by the ongoing legal fight over the termination — and attempted return to the company — of The LTV Corp.'s underfunded pension plans.

But his tenure also covered several other major fights:

- A federal court ruled last November that Navistar International Corp. was liable for a portion of the unfunded pension liabilities of its former Wisconsin Steel unit, which had been sold off in 1977 and whose underfunded pension plans subsequently were terminated in May 1981 (*Pensions & Investment Age*, Nov. 28, 1988).
- The full 11th U.S. Circuit Court of Appeals supported the PBGC's view that employers do not have to pay out anticipated benefits before recapturing surplus assets (*P&I Age*, July 25). The agency had filed a friend-of-the-court brief in the case, Blessitt vs. Dixie Engine Co.

Mr. Ford also was instrumental in securing legislation requiring tougher funding standards and a variable rate premium for the agency in the 1987 Pension Protection Act. ■

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CORRECTIONS & CLARIFICATIONS

- The **Russell 3000 Index** return for the month of October was 2.04. The monthly index figure was reported incorrectly in the Nov. 14 *P&I Age* October indexes.
- The location of **BARRA**, the investment management consulting firm, was reported incorrectly in the Jan. 23 issue. BARRA is located in Berkeley, Calif.
- A story in the Feb. 20 issue on **Pan American World Airways Inc.**'s proposed transfer of its leasehold interest to five of its pension plans should have said the transaction might not be enough to keep the airline independent, but will help the airline in conserving its cash. Also, as of Sept. 14, the value of Pan Am World Services Inc. stock, held as collateral for unpaid pension contributions, was increased to $104.5 million from $75 million.
- In the annual PIPER rankings published in the Feb. 20 issue, the return for the Standard & Poor's 500 Stock Index placed in the fourth decile for the 10-year period. An incorrect decile ranking was printed.

Passive leads way for the short term

By Curtis Vosti

International indexing led the way among commingled international funds for the quarter and year ended Dec. 31, according to Pensions & Investments' Performance Evaluation Report.

The top six performers for the quarter among PIPER's 42-fund international universe were index managers. The same six were the top performers for the year.

Wells Fargo Investment Advisors, San Francisco, had the best performing fund for both the quarter and the year, returning 15.55% and 28.49% respectively. Those numbers, however, weren't enough to beat the Morgan Stanley Capital International Europe Australia Far East Index, which returned 15.7% for the quarter and 28.6% for the year.

"I wish we could claim special knowledge, but the phenomenon relates to the underperformance of active international managers," said Patricia Dunn, president of Wells Fargo.

She cited a recent study that she said indicates the average active international manager underperformed EAFE by 10 percentage points a year for the past six years. "Ninety percent of what plan sponsors get will just be for being in the markets," she said.

Wells Fargo manages about $1.29 billion in pension fund assets indexed internationally.

The commingled international indexed fund managed by Travelers Investment Management Co., Hartford, Conn., finished second for the quarter with a 15.04% return.

Unlike most, Travelers follows the Financial Times-Actuaries Europe-Pacific Index. Because the FT index is broader based than EAFE, Kent Kelley, executive vice president, said the firm uses a sampling strategy, and holds 950 issues in 10 countries, compared with the FT's 1,700 issues in 20 countries.

The international index fund of State Street Bank and Trust Co., Boston, finished third for both the quarter and the year with returns of 15.0% and 27.8%, respectively.

Peter Braun, vice president and director of mar-

Continued on page 31

Commingled international funds

3-month returns

	%
MSCI EAFE Index	**15.7**
Wells Fargo (Eq.), Calif.	15.6
Travelers (Index), Conn.	15.0
State Street Bank (Index), Mass.	15.0
American Nat'l Chicago (Eq.)	14.9
Chase Investors (EAFE index)	14.6
Prudential (Index), N.J.	14.3
NCNB Texas (Stock)	13.2
Chase Investors (Eq.), N.Y.	12.9
Centerre Trust (Coll. W), Mo.	12.3
Wellington Trust (Pacific Basin)	12.2
Morgan Guaranty (Eq.), N.Y.	12.1
U.S. Trust (Eq.), N.Y.	11.9
Bessemer Trust (E), N.Y.	11.8
Provident Capital (Low p/e), Pa.	11.6
First Chicago (Eq.)	11.4
MSCI World Index	**11.4**
Wellington Trust (Stock)	11.0
WorldInvest (Eq.)	10.9
Bankers Trust (Eq.), N.Y.	10.8
Aetna Capital-ACMI (Eq.), Conn.	10.8
Putnam Fiduciary Trust	10.7
Confederation Life (Stock), Ga.	10.2
CIGNA (Eq.), Conn.	9.8
California First Bank (Invt. eq.)	9.7
PCM Int'l (Foreign bond), N.J.	9.6
IDS Trust (Coll. eq.), Minn.	9.5
Travelers (Eq.), Conn.	9.4
WTC Capital (Coll. eq.), Del.	9.3
Wellington Trust (Emerg. eq.)	8.9
Fidelity Mgmt. (Overseas eq.)	8.7
Morgan Guaranty (Bond), N.Y.	8.4
Equitable Capital (Port. 20), N.Y.	8.1
Connecticut Mutual (Overseas)	8.0
PCM Int'l (PRINT eq.), N.J.	7.7
PCM Int'l (Global yield), N.J.	7.2
Lincoln Nat'l (SA 22), Ind.	7.2
PCM Int'l (Global bond), N.J.	7.0
First Chicago (Non-$ fixed)	6.8
WorldInvest (Fixed)	6.8
IAA Trust (CTF-I), Ill.	5.1
Marine Midland (Eq.), N.Y.	4.6
Assoc. Bank Neenah (World)	3.3
Trust Co. of the West (Global)	2.4

1-year returns

	%
MSCI EAFE Index	**28.6**
Wells Fargo (Eq.), Calif.	28.5
Prudential (Index), N.J.	28.1
American Nat'l Chicago (Eq.)	27.8
State Street Bank (Index), Mass.	27.8
Chase Investors (EAFE index)	27.3
Travelers (Index), Conn.	26.8
Confederation Life (Stock), Ga.	26.3
Provident Capital (Low p/e), Pa.	24.2
MSCI World Index	**23.9**
Chase Investors (Eq.), N.Y.	22.0
Wellington Trust (Pacific Basin)	21.9
Assoc. Bank Neenah (World)	21.2
U.S. Trust (Eq.), N.Y.	20.7
First Chicago (Eq.)	20.1
Wellington Trust (Stock)	19.8
NCNB Texas (Stock)	18.9
Centerre Trust (Coll. W), Mo.	18.5
Wellington Trust (Emerg. eq.)	18.0
Bessemer Trust (E), N.Y.	17.9
Aetna Capital-ACMI (Eq.), Conn.	17.8
WorldInvest (Eq.)	17.4
Lincoln Nat'l (SA 22), Ind.	17.1
Morgan Guaranty (Eq.), N.Y.	16.8
PCM Int'l (PRINT eq.), N.J.	16.2
Bankers Tust (Eq.), N.Y.	15.7
PCM Int'l (Global yield), N.J.	15.0
CIGNA (Eq.), Conn.	13.9
IDS Trust (Coll. eq.), Minn.	13.4
WTC Capital (Coll. eq.), Del.	13.3
Trust Co. of the West (Global)	12.3
PCM Int'l (Global bond), N.J.	12.3
Putnam Fiduciary Trust	11.4
Travelers (Eq.), Conn.	11.3
California First Bank (Invt. eq.)	11.0
Fidelity Mgmt. (Overseas eq.)	10.7
Connecticut Mutual (Overseas)	7.9
Marine Midland (Eq.), N.Y.	7.0
Morgan Guaranty (Bond), N.Y.	5.9
PCM Int'l (Foreign bond), N.J.	5.3
First Chicago (Non-$ fixed)	5.1
Equitable Capital (Port. 20), N.Y.	4.5
IAA Trust (CTF-I), Ill.	4.2
WorldInvest (Fixed)	2.1

3-year returns

	%
Wellington Trust (Pacific Basin)	41.3
American Nat'l Chicago (Eq.)	40.8
Wells Fargo (Eq.), Calif.	40.0
State Street Bank (Index), Mass.	39.9
Chase Investors (EAFE index)	39.8
MSCI EAFE Index	**39.8**
Prudential (Foreign stock), N.J.	39.1
Provident Capital (Low p/e), Pa.	35.8
WorldInvest (Eq.)	34.8
U.S. Trust (Eq.), N.Y.	32.3
Chase Investors (Eq.), N.Y.	31.9

Continued on page 30

Indexing becomes much more than a trickle in U.K.

By Michael Gray

The flow of British pension assets into indexed management has not yet become a flood, but the tide rolling in.

Although no one has any precise figures, surprisingly uniform estimates say 5%, or about $21 billion, of pension fund assets are passively managed. And there probably is another $10 billion in overseas assets managed by London managers, said Bruce Pullman, a director for County NatWest Investment Management, London. About 20% percent of the U.S. market or about $150 billion is passively managed in the United States.

"We've seen it grow significantly and have talked to a lot of people about it," said Tim Gardener, the head of asset planning for William Mercer Fraser, a London investment management firm. "More often then not, they are coming in asking us about it. It's fairly hot at the moment."

Although index funds have been popular in the United States since the early 1980s, they have been a serious option for U.K. pension directors only for about two years.

"No one wants to be the first to go in. Now that the big firms are in, it has credibility. It is no longer a novelty," Mr. Gardener said.

David Hager, a partner at Bacon & Woodrow Investment Services Ltd., London, agreed with Mr. Gardener's assessment. "We've had substantial funds moved (into passive) by a large number of firms," he said, more than $1.7 billion since December.

"It is particularly the large funds that do not want the rough ride," said Bruce Pullman of County NatWest Investment Management, London, one of the leaders in the trend toward passively managed funds.

"Eighteen months ago there was only ($3.5 billion) indexed," he estimated. "There has been a dramatic shift; the money is coming out of balanced management," Mr. Hager said.

"And this ignores a large amount of closet indexation," he said, referring to active managers who closely replicate the index. With closet indexation, pension funds are "paying active service fees for passive management that doesn't give much difference," he said.

Management fees play a small but nagging role in the reasoning behind a shift to indexation, managers said. But in the long run, most agree any savings is minimal at best because the reduced cost of passive management is balanced by the increased cost of one or two active managers employed to run the satellite portions of the fund.

Most U.K. pension funds are moving toward core passive management with active sectors, said James Woodlock, a director for Barclays de Zoete

Continued on page 30

UPDATE

Bond model offered

BERKELEY, Calif. — BARRA and Nikko Securities Inc. have teamed up to offer money managers a guide for investing in Japanese bonds.

The BARRA-Nikko Fixed Income Service provides a fully integrated and flexible framework for managers investing in the Japanese fixed-income market, according to Daniel Beck, director of product development for BARRA, the investment consulting firm in Berkeley.

The service, known as BNFIS, builds on the methodology developed by BARRA to help managers understand the U.S. bond market, Mr. Beck said.

He said the service has been in distribution in Japan since November, and has three clients. It will officially be released in the second quarter, he said.

The system uses daily and monthly quoted prices for several thousand securities to establish a model of the elements of investment value using the daily term structure of interest rates. The term structure is fully specified by interest rates prevailing over a grid of nine time intervals, he said.

Additional adjustments include spreads calculated for municipal securities, Japanese railway construction securities, Tokyo and other utilities, finance, other guarantees and a benchmark bond. The service calibrates investment risk to events in the Japanese fixed-income market during the past 10 years.

Trading data out

NEW YORK — Asian investors posted a record $40.7 billion of gross trading of U.S. equities during the third quarter, for the first time exceeding Europeans' gross activity, according to the Securities Industry Association.

But on a net basis, Asian investors sold $94 million of U.S. equities during the third quarter, while Europeans were net sellers of $103 million of U.S. securities, said the SIA. Europeans were responsible for $35.9 billion in gross trading.

Among U.S. investors, purchases and sales of foreign equities totaled $36.4 billion in the third quarter, bringing the annual pace to $143 billion. If sustained through the fourth quarter, it would represent the second highest annual showing ever, although still 24% lower than 1987's record $189 billion in gross trades, according to the SIA.

U.S. investors' net purchases of foreign stocks stood at a relatively low $200 million annual pace last year, based on nine months' data. "If the final 1988 quarter continued the pace, U.S. net purchases of foreign stocks would, except for 1987, be at the lowest level since 1981 when U.S. investors bought $200 million of foreign equities," according to the SIA.

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Wedd Investment Ltd., London. "Indexing seems to allow managers to be much more aggressive," he said.

Fees are generally lower by one-third than in the United States. "In the long term, I see the prices going up. (Fund managers) will be asking themselves, 'What am I getting for active management?' Not much in some cases. Passive is a nice cheap alternative," Mr. Hager said.

Westland Group PLC, London, shifted $227 million of its $394 million pension fund into passive management with Barclays a year ago. "We hadn't been pleased with our previous manager's performance," said Mike Westland, group pensions manager. The review was prompted by the merging of the company's hourly and staff funds.

Other companies that have shifted more of their funds into indexing in the recent past have been: The Rover Group Ltd., The Plessey Co. PLC, John Lewis Partnership, Grand Metropolitan PLC and Woolworth Holdings PLC, Mr. Woodlock said.

"In looking over the performance of our active managers, we had to establish whether they are active managers or really closet indexers," said John Suckling, director of Rover Group Staff and Hourly Paid Pension Schemes.

For Rover, nearly their entire $1.4 billion staff portfolio has been indexed, with the exception of 5% in venture capital, 8% in properties, the rest indexed or cash managed, he said. For hourly paid, slightly more than 50% of the $875 million fund is indexed.

Mr. Suckling said the October 1987 market crash had nothing to do with the change to passive management. "We were looking at performance over a long period. We cut out risk."

The look to passive management started in 1986, he said. "We put our toe in the water, setting up a relatively small index fund for our U.K. operation." After further investigation, especially after the poor performance of overseas funds, fund officials considered indexing more seriously, he said. "Certainly overseas — Europe, the U.S., Japan — they were significantly outperformed," he said of his active managers.

"(Overseas) is no place for active managers," he said. "1987 was the crash, and 1988 was a flat year, no place for active managers to show significant place or outperformance," he said, "Active managers can add value. Its a question of keeping those managers and accepting those sorts of philosophies," Mr. Suckling said.

Another relatively recent convert is Grand Metropolitan which recently shifted 25%, or $297 million of its fund into passive management, 75% of which is U.K. and the other 25% in the world index, said Michael Coombe, pension fund secretary.

The shift allows the active side of the fund to be managed more aggressively, Mr. Coombe said, noting there is room for an increase in passively managed funds.

"Pure performance is missing the real point," Mr. Pullman said, regarding the motivation to shift to passive from active. "I compare it with buying retail clothes. You could spend an awful lot to have a tailor-made suit that would look extremely nice. But if you happen to be the right size, one from (department store) Marks & Spencer off the peg could fit you very well. For certain funds, (passive) is the perfect suit of clothes."

On the other hand, "Active managers are not as awful as they look," said Tony Dye, a director for Phillips and Drew, a firm that "is very keen on active management" but has a passive branch as well.

"On aggregate, the index has not delivered the goods," he said. "We point out the pitfalls. If you are not fully indexed, you can get subindex returns when odd things happen."

In U.K. equities for the five years ended Dec. 31, 1988, Phillips and Drew returned 21.4%. The median, as measured by The WM Co., Edinburgh, Scotland, was 18.2% for the same period, and the Financial Times-Actuaries All Shares Index returned 19.5%, he said.

Public funds have been relatively slow to follow the corporate trend toward indexing. Only about $2.5 billion to $3.5 billion is indexed at the moment but it appears the stage is set for a large increase.

One of the indexing leaders in the English public sector is Gloucestershire County. Fund officials made the switch more than two years ago and now manage their $350 million fund in-house, said Sue Timbrell, the investment manager for the county council.

"We wanted to get more imaginative. I suggested indexation," she said. Now at least two neighboring counties — Devon and Dorsett — have followed her lead.

"It was much cheaper, with similar (performance) results. We liked the concepts: increased performance, reduced management fees and we wanted to increase our expertise in the office," she said. ■

Continued from page 29

Bankers Trust (Eq.), N.Y.	31.9
Bessemer Trust (E), N.Y.	31.7
First Chicago (Eq.)	31.1
Fidelity Mgmt. (Overseas eq.)	30.3
CIGNA (Eq.), Conn.	29.5
Centerre Trust (Coll. W), Mo.	29.5
Marine Midland (Eq.), N.Y.	29.4
Confederation Life (Stock), Ga.	28.4
Aetna Capital-ACMI (Eq.), Conn.	27.8
NCNB Texas (Stock)	27.4
MSCI World Index	**27.4**
PCM Int'l (Global bond), N.J.	26.2
California First Bank (Invt. eq.)	26.1
Wellington Trust (Stock), Mass.	25.9
Morgan Guaranty (Eq.), N.Y.	25.9
Equitable Capital (Port. 20), N.Y.	25.6
First Chicago (Non-$ fixed)	25.4
PCM Int'l (Foreign bond), N.J.	25.1
IDS Trust (Coll. eq.), Minn.	24.4
Putnam Fiduciary Trust	22.8
WorldInvest (Fixed)	22.5
Morgan Guaranty (Bond), N.Y.	22.0

5-year returns

	%
MSCI EAFE Index	**35.8**
American Nat'l Chicago (Eq.)	35.6
Wells Fargo (Eq.), Calif.	34.9
WorldInvest (Eq.)	30.1
Wellington Trust (Pacific Basin)	29.8
Bankers Trust (Eq.), N.Y.	29.7
First Chicago (Eq.)	28.8
U.S. Trust (Eq.), N.Y.	26.4
PCM Int'l (Global bond), N.J.	26.3
Aetna Capital-ACMI (Eq.), Conn.	26.3
Bessemer Trust (E), N.Y.	26.2
Chase Investors (Eq.), N.Y.	26.1
Marine Midland (Eq.), N.Y.	26.1
Putnam Fiduciary Trust	25.8
MSCI World Index	**25.4**
Wellington Trust (Stock), Mass.	24.9
NCNB Texas (Stock)	24.6
IDS Trust (Coll. eq.), Minn.	24.4
Centerre Trust (Coll. W), Mo.	24.1
Morgan Guaranty (Eq.), N.Y.	22.6
PCM Int'l (Foreign bond), N.J.	22.2
First Chicago (Non-$ fixed)	21.5
WorldInvest (Fixed)	21.2
Morgan Guaranty (Bond), N.Y.	19.3

10 year returns

	%
U.S. Trust (Eq.), N.Y.	22.6
MSCI EAFE Index	**22.3**
First Chicago (Eq.)	19.8
MSCI World Index	**19.5**
Morgan Guaranty (Eq.), N.Y.	17.6

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Passive leads

Continued from page 29

keting, said the $1.6 billion fund tries to replicate the EAFE index in both market weighting and stock selection. "One of the advantages of replication is that the need for balancing is very minor, and it keeps transaction costs to a bare minimum," he said.

The top performing active international manager for the fourth quarter was NCNB Texas Asset Management, Dallas. Its international stock fund returned 13.22%. Steve Myres, portfolio manager at the firm, said the $15 million fund uses a bottom-up approach to pick fast-growing companies that it can buy as cheaply as possible.

It holds about 50 issues with a normal annual turnover of 50% to 75%, Mr. Myres said. But turnover was higher in 1988 because of redemptions for clients whose increased international valuations exceeded guidelines.

The fund is overweighted in West Germany, France, Singapore and Hong Kong, Mr. Myres said, and underweighted in the United Kingdom and Japan.

Chase Investors International, the London-based subsidiary of Chase Investors Management Corp., was the second best active manager for the fourth quarter, returning 12.9%.

Rosalind Altmann, executive director, said the $125 million active fund has 70 to 80 issues and a turnover of about 40% per year.

Ms. Altmann said the fund invests along three main themes: a top-down approach, viewing currencies and markets separately and stock selection.

"We look to judge both markets and currencies and add value at both ends," she said. "We are looking at currencies as a separate asset class."

So, for example, while underweighted in the Japanese market, the fund is overweighted relative to the yen. The firm does this through forward sales of the values of its equity holdings.

Top holdings for the fund include the Belgium-based **Bekaert,** the Dutch **Hunter Douglass** and German-based **MAN** and **Linde.**

Investment Index Technologies, a subsidiary of Prudential Asset Management, Newark, N.J., was the second best PIPER performer for the year with a 28.12% return on its indexed fund.

The $262 million fund is invested in all the same countries as EAFE. Though Vice President David Hurley and Portfolio Manager John Moshberger say the fund does not hold all 1,023 stocks in the index, it does replicate country weightings. The portfolio typically has about 600 stocks and stays fully invested, Mr. Hurley said.

Active management finally had its day for the three-year period. The Pacific Basin Portfolio of Wellington Trust Co., Boston, finished at the top, returning 41.33%, compared with the EAFE return of 39.42%. It was also one of the top performing active international managers in the fourth quarter, returning 12.9%.

The MSCI Pacific Basin Index, however, returned 52.97% for the same three-year period.

According to Jerry Mitchell, senior vice president at Wellington Trust, the $7 million fund typically holds about 60 stocks. "Our philosophy is to invest in high-quality companies and companies with market leadership positions in their industries," he said.

The firm also defines some socioeconomic long-term trends and invests accordingly, he said. There is not a lot of turnover. "We'll hold and let the trend push that stock price," he said.

For example, Wellington bought **Singapore Airlines** about three or four years ago, Mr. Mitchell said, and it has more than tripled in value.

Another top performing active manager was WorldInvest Ltd., London. Its international employee benefit equity fund, with slightly less than $60 million in assets, was the third-best performer for the five-year period with a 30.06% return.

According to Ali Ansari, investment manager, the actively run fund follows a top-down strategy. Turnover on the approximately 60 stocks in the portfolio averages between 75% and 100% a year.

The fund differs from the EAFE weightings significantly, Mr. Ansari said, particularly in Japanese stocks, where the fund is currently at less than 10% invested, compared with about 65% for the index. The amount of Japanese investments has been trimmed during the past three years, he said.

"Our biggest position has been in the United Kingdom," where about 28% of the portfolio's assets are invested, he said. There are also significant holdings in Spain and Canada, both of which are about 9%, he said.

The fund is weighted primarily toward the secondary goods and mechanical transport sectors, he said. It is underweighted in the financial services sector.

"Following the crash (Oct. 19, 1987) there was much concern that a recession would follow," he said. "We did not share in that view," and so began buying cyclical and growth stocks.

The fund has holdings in **Peugot,** the French automaker, **Atlas Copco,** the Swedish mining and capital equipment firm, the U.K.-based **Glaxo** and the French chemical giant, **Rhone Poulenc.**

American National Bank of Chicago's $300 million equity fund finished second for the three-year period and first for the five-year period among the PIPER international equity funds, with respective returns of 40.83% and 35.57%.

According to Stephen Manus, managing director of equity indexing, the fund replicates EAFE as much as possible, but is invested in only 12 of the 18 countries in the index. ■

West German bank creates relations unit

NEW YORK — With an eye on the upcoming creation of a unified European Community in 1992, Deutsche Bank AG has established an international investor relations group to handle the information requirements of investors throughout the world.

Deutsche Bank is believed to be one of the first large West German companies to formalize an investor relations effort.

Foreign investors comprise 40% of the ownership of the Deutsche Bank.

It is the largest commercial and investment bank in West Germany.

Deutsche Bank has a 24% share of the West German mutual fund business.

It also holds a 20% share of the institutional money management market. ■

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Associated Bank best in quarter

Special equity funds
(periods ended Dec. 31, 1988)

	Quarter	1 yr.	3 yr.	5 yr.	10 yr.
Highest return	17.03%	53 %	56.02%	36.01%	25.06%
First quartile	2.71	27.69	14.5	12.8	19.03
Median	1.33	18.4	10.65	9.9	16.38
Third quartile	−0.62	12.7	5.4	6.64	14.16
Lowest return	−4.27	1.79	−5.55	−2.57	12.76
Russell 2000	**4.96**	**25.31**	**7.1**	**9.05**	**16.31**
S&P 500	**3.05**	**16.57**	**13.35**	**15.32**	**16.36**

By Trudy Ring

A yield-oriented fund was the top-performing pooled special equity fund in the fourth quarter, nearly tripling the return of its nearest competitor.

Neenah, Wis.-based Associated Bank's equity income fund returned 17% in the quarter, putting it at the top of Pensions & Investments' Performance Evaluation Report's universe of 85 special equity funds managed by banks and insurance companies. Second, with 5.8%, was Mid-State Bancorp, Altoona, Pa., with its Beta fund.

The median return in the quarter was 1.3%, less than the 3.1% returned by the Standard & Poor's 500 Stock Index. The Russell 2000 returned 5%.

For calendar year 1988, the median special equity return was 18.4%, while the S&P 500 returned 16.6% and the Russell 2000, 25.3%. For the three years ended Dec. 31, the median fund returned a compound annualized 10.7%; the S&P 500, 13.4%; and the Russell 2000, 7.1%.

For the five years ended Dec. 31, the median fund had 9.9%; the S&P 500, 13.6%; and the Russell 2000, 9.1%. For the 10-year period, the respective returns were 16.4%, 16.4% and 16.3%. All returns for more than a year are compound annual.

Associated Bank's equity income fund has a goal of capital appreciation plus above-average current yield, said Ken Brusda, vice president, trust officer and one of the fund's seven equity analysts.

The fund typically puts between 50% and 60% of its assets in stocks with an annual dividend yield of at least 4%. It invests 15% to 20% in convertible bonds and convertible preferred stock, about 10% in real estate investment trusts and 10% to 25% in lower-yielding growth stocks on which it writes covered call options.

The $10 million fund stays fully invested and has low turnover, about 15% to 20% a year. It holds about 50 issues, each typically 2% to 5% of the portfolio. A few holdings are bigger; its largest position is in **Philip Morris Cos. Inc.**, which makes up about 8% of the fund.

Philip Morris fits the high-yield strategy, with a current yield of about 4.1%, Mr. Brusda said. It increased its dividend last year and likely will do so again this year, he said.

Other high-yield stocks in the fund include **USF&G Corp., Texas Utilities Co.** and **Commonwealth Edison Co.** One of the convertible bonds is **Plenum Publishing Corp.** A convertible preferred issue that fared well was **Triangle Industries Inc.**, bought out by a French company in the fourth quarter. One of the growth stocks, on which the fund has written calls, is **AMP Inc.**

The fund also performed well for longer periods. "The dividend yield gives it some stability that the market wouldn't have," Mr. Brusda said. Its 40.3% return for the year placed it fifth among all funds. For the three-year period it was sixth, with a compound annual 18.9%. For the five-year period it was third, with 20.2%. It is too new for the 10-year period.

Mid-State Bancorp's $5 million Beta fund, managed by its Mid-State Capital Management unit, invests in small-capitalization stocks. Selection is based on a price movement model and the portfolio managers' comfort with the issuing companies' management, said Ralph J. Davis, director of Mid-State Capital. Some of the companies might be takeover targets and some are just beyond the initial public offering stage, he said.

The fund relies heavily on outside research; some of the best has come from Cyrus J. Lawrence Inc., New York, Mr. Davis said.

The fund usually has about 20 stocks, weighted from 3% to 9% of the portfolio. It stays fully invested and has annual turnover of about 100%. Holdings include **Copytele Inc., Chronar Corp.** and **The Kroger Co.**

The fund placed in the top 30% for the year, with a 28.3% return. For the three- and five-year periods, it was below the median, with 7.9% and 8.8% respectively. It is too new for the 10-year period.

The past few years have been poor for small-cap stocks, Mr. Davis noted. "We have felt that our continued dedication to this

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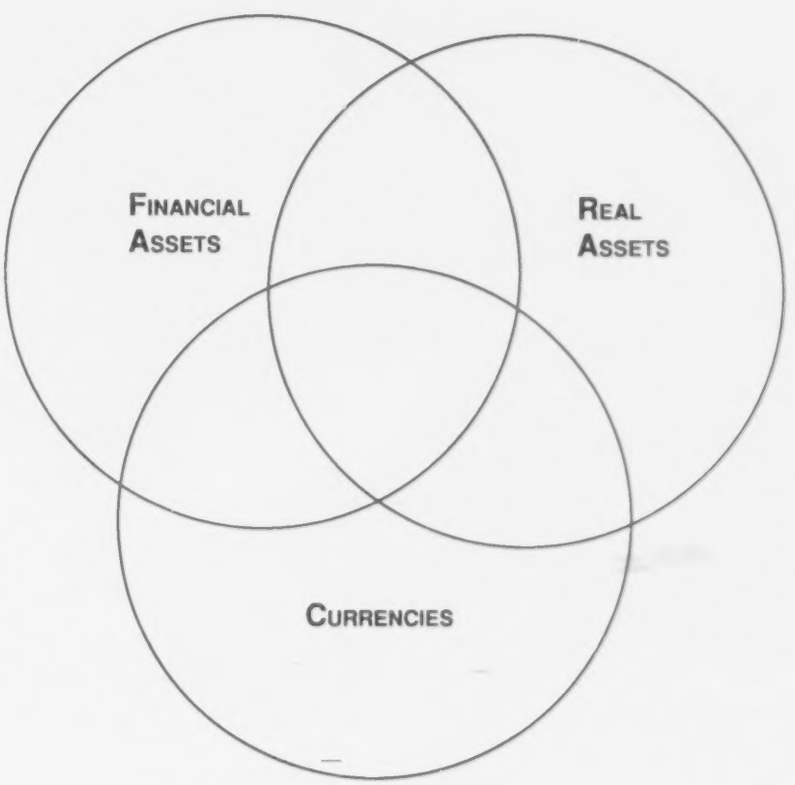

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Best fund

Continued from page 32

thing would pay off," he said.

He added Mid-State Capital measures the fund against the Value Line Index, made up of 1,700 equally weighted stocks. In every period, it has outperformed Value Line, which returned −0.86% for the quarter, 15.4% for the year, 2.7% for the three years and 3.7% for the five years.

Third for the quarter, with a 5.7% return, was the employee benefit supplemental fund offered by Connecticut Bank and Trust Co., Hartford. The $70 million fund invests in small-cap stocks, with tilts toward growth and technology issues, said Harry Sterling Jr., managing director of Constitution Capital Management, Boston and Hartford, which manages the fund. Both the bank and the management firm are subsidiaries of Bank of New England Corp., Boston.

Fund management picks stocks from three universes — core or emerging growth; improving growth; and opportunity, or undervalued, stocks. Examples of each, in order, are **Mentor Graphics Corp.**, **Texas Industries Inc.** and **Metro Mobile CTS Inc.** The fund usually carries 60 to 70 stocks, in various weightings, and stays fully invested, Mr. Sterling said.

Its 1988 return was 28.7%, placing it in the top 20% of the PIPER universe. It was slightly above the median for the three-year period, with 11.4%, and just below it for the five years, with 9%. It was back in the top 20% for the 10-year period, with 20.1%.

First for the year was Boston-based Wellington Trust Co.'s special situation fund, with 53%. The $3 million fund holds 20 to 30 stocks, weighted about equally, stays at least 90% invested and has annual turnover of 20% to 30%, said Bob Beck, managing director of Marble Arch Partners, a joint venture between its principals and Wellington Management Co., Wellington Trust's parent.

It uses fundamental research to identify undervalued companies whose value is likely to be realized in the next few years. Holdings include **UST Inc.**, **Citicorp** and **CBS Inc.**

The fund returned 1.6% in the quarter, slightly above the median. It is too new for periods longer than a year.

Leader for the three- and five-year periods was NCNB Texas National Bank's select equity fund, with 56% and 36% respectively. The $20 million fund is concentrated in a few stocks; there now are just five in the portfolio. The cash position can vary widely, depending on whether the fund's management can find stocks it likes; the fund was 80% in cash at year end and is now down to about 50%, said David Gardner, vice president.

The fund focuses on large-cap issues with price-earnings ratios that are low relative to their industry groups. The entire fund turns over about twice a year. Holdings at year end included **Gibson Greetings Inc.** and **Eagle-Picher Industries Inc.**; since then, it has added **Anheuser-Busch Cos. Inc.**, **Datascope Corp.** and **Ramada Inc.**

Top fund for the 10-year period was the $15 million supplemental equity fund managed by Union Bank (formerly California First Bank), San Diego, with 25.1%. It seeks small-cap companies with accelerating growth, said David Urben, investment officer and funds manager.

Holdings include **Advanced Marketing Services Inc.** and **The Flight International Group Inc.** ■

Top quartile commingled special equity funds

3-month returns

	%
Assoc. Bank Neenah (Inc.), Wis.	17.0
Mid-State Bancorp (Beta), Pa.	5.8
Connecticut Bank (Emp. sup..)	5.7
Russell 2000	**5.0**
Equitable Capital (Tangible), N.Y.	4.9
Fidelity Mgmt. (Sm. co.), Mass.	4.9
Banc One Asset, Ohio	4.7
SLH Trust (New values 3), Del.	4.4
Hibernia Nat'l (G), La.	4.4
Chase Investors (Inter.), N.Y.	4.2
Massachusetts Mutual (SIA S)	4.2
NCNB Texas (Select)	3.9
Chase Investors, N.Y.	3.6
Fidelity Mgmt. (Agg.), Mass.	3.5
Provident Capital, Pa.	3.4
Boatmen's Trust (P-1), Mo.	3.4
Markston Investment (VA 15), N.Y.	3.2
Chancellor, N.Y.	3.2
Wells Fargo (Tilts & timing), Calif.	3.2
First Wisconsin Asset (Growth B)	3.1
Standard & Poor's	**3.1**
Nat'l Bank of Detroit (Opp.)	2.8
First Chicago (Inst.)	2.8
Assoc. Bank Neenah (Reg.), Wis.	2.8

1-year returns

	%
Wellington Trust (Spec. sit.)	53.0
Society Nat'l (Central value), Ohio	47.3
Connecticut Nat'l (Sup.)	45.8
First Wis. Asset (Emerg. growth)	41.1
Assoc. Bank Neenah (Inc.), Wis.	40.3
Fidelity Mgmt. (Sm. co.), Mass.	37.3
Trust Co. of the West (Value)	35.7
Meridian Trust (Quest), Pa.	34.7
Boatmen's Trust (P-1), Mo.	34.7
Assoc. Bank Neenah (Reg.), Wis.	33.1
Wellington Trust (Non-tech)	31.9
Massachusetts Mutual (SIA S)	31.8
Wellington Trust (Emerg. tech.)	31.1
First Wachovia (Value), N.C.	29.9
Texas Commerce	29.0
Chancellor (Value), N.Y.	28.8
Connecticut Bank (Emp. sup.)	28.7
Mid-State Bancorp (Beta), Pa.	28.3
Bank One Asset, Ohio	28.2
NCNB Texas (Select)	28.0
First Chicago (Inst.)	27.9
Russell 2000	**25.3**
Standard & Poor's	**16.6**

3-year returns

	%
NCNB Texas (Select)	56.0
SLH Trust (New values 3), Del.	28.5
SLH Trust (Growth 2), Del.	26.5
Equitable Capital (Tangible asset)	23.2
First City Nat'l Houston (G-1)	22.2
Assoc. Bank Neenah (Inc.), Wis.	18.9
Assoc. Bank Neenah (Reg.), Wis.	18.1
Nat'l Bank of Detroit (Intrinsic F)	17.9
Connecticut Nat'l (Sup.)	17.8
Society Nat'l (Central value), Ohio	16.5
Massachusetts Mutual (SIA S)	16.4
The Phoenix (Growth S), Conn.	16.0
Fidelity Mgmt. (Agg.), Mass.	15.9
Harris Trust (Capital), Ill.	15.8
Security Pacific (Growth G), Calif.	15.7
First Chicago (Inst.)	15.4
Society Nat'l (Momentum), Ohio	15.0
Fidelity Mgmt. (Small co.), Mass.	15.0
Central Fidelity (Agg.), Va.	14.7
Wells Fargo (Tilts & timing)	14.3
Standard & Poor's	**13.4**
Russell 2000	**7.1**

5-year returns

	%
NCNB Texas (Select)	36.0
SLH Trust (Growth 2), Del.	27.8
Assoc. Bank Neenah (Inc.), Wis.	20.2
Equitable Capital (Tangible asset)	19.1
Fidelity Mgmt. (Agg.), Mass.	18.3
Chancellor (Real estate)	15.4
Standard & Poor's	**15.3**
Connecticut Nat'l (Sup.)	15.2
Chancellor (Sp. value)	15.2
Chase Investors (Inter.), N.Y.	15.0
First Wis. Asset (Growth B)	13.5
Mellon Equity Associates	13.5
Nat'l Bank of Detroit (Opp.)	13.4
Trust Co. of the West, Calif.	13.2
Chancellor (Emerg. health)	12.9
Russell 2000	**9.1**

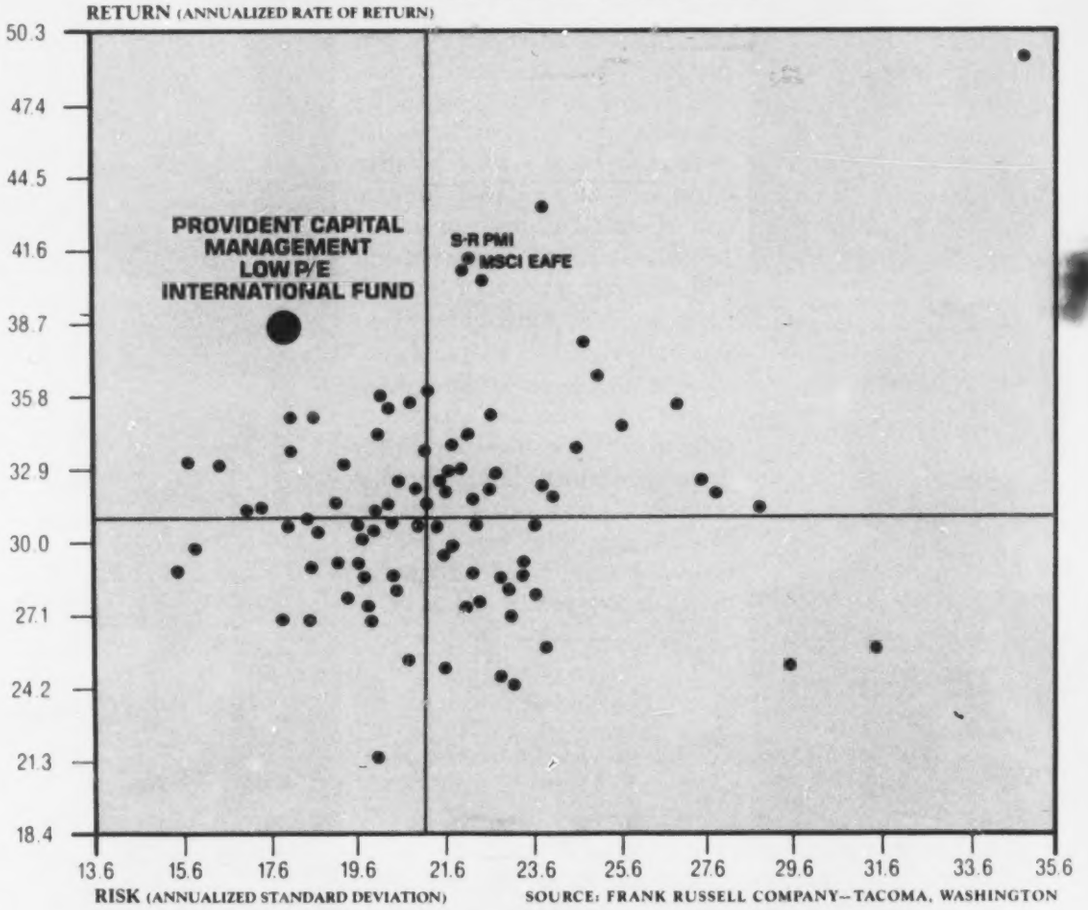
10-year returns

	%
California First Bank (Sup.)	25.1
MTrust (Growth), Texas	21.5
Norwest Bank (Sp. invt.)	20.9
Chancellor (Value), N.Y.	20.4
Connecticut Bank (Emp. sup.)	20.1
Chase Investors (Inter.), N.Y.	19.8
Bank of America (Cit.), Calif.	19.5
First Chicago (Inst.)	19.0
Standard & Poor's	**16.4**
Russell 2000	**16.3**

Low P/E works overseas, too.

RISK-RETURN COMPARISONS FOR NON-U.S. EQUITY PORTFOLIOS

3 YEARS ENDING SEPTEMBER 30, 1988



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Mortgage bonds hit standstill

By Steve Hemmerick

Investments by the nation's largest pension funds in mortgage-backed securities fell 3% in the year ended Sept. 30, the second year of virtually no growth in that asset class following several years of almost stratospheric increases.

Consultants, pension executives and money managers said rising short-term interest rates and a narrowed spread between mortgage-backed securities and U.S. Treasury instruments was a key factor for the decline during the year.

According to *Pensions & Investment Age*'s survey of the 200 largest pension funds, investments in mortgage-backed securities fell $1.6 billion to $49.9 billion as of Sept. 30, 1988, from $51.6 billion a year earlier and $50.5 billion as of Sept. 30, 1986.

Another possible reason for the decline, however, comes from a change in the Top 200 survey. This year, *P&I Age* specified use of defined benefit plan assets; this excluded defined contribution plans that had appeared on previous years' lists, such as the Teachers Insurance and Annuity Association — College Retirement Equities Fund.

Seventy-eight of the 200 funds reported investments in mortgage-backed securities.

Until recently, however, growth in that asset class had been steep, increasing 64% during the year ended Sept. 30, 1986, for example.

Pension fund holdings in mortgage-backed securities change day to day because investors quickly move in and out of that market. Rising short-term interest rates last year not only caused investors to move out of mortgage-backed securities, but also slowed the volume of securitized mortgages brought to the market.

One fund — the $20 billion New Jersey Division of Investment — increased its holdings about 19% during the year ended Sept. 30, yet began selling off securities with weighted average lives of 20 to 22 years in 1988 in favor of buying 10-year and shorter Treasuries because of the specter of rising short-term interest rates.

Roland Machold, director of the New Jersey fund, said officials wanted to shorten maturities on the fixed-income portfolio before interest rates rose. He said he couldn't estimate how much was sold.

About the sale of mortgage-back securities prior to rising interest rates, Carl Kane, a partner in the New York office of the consulting firm Kenneth Leventhal & Co., said, "It's interesting (money managers) were that prescient."

Pension funds primarily buy mortgage-backed securities for their high-quality ratings and slightly higher returns than Treasury securities.

"It so happened in 1988 we were 30% (invested in mortgage-backed securities) in most of our (fixed-income) portfolios," said Steve Thalasinos, a portfolio manager with First Boston Asset Management Corp. in Los Angeles.

First Boston is a fixed-income manager for the $2.8 billion Los Angeles Fire and Police Retirement System, whose managers eliminated fund holdings in mortgage-backed securities during the year ended Sept. 30. The fund had $139 million in that asset class previously.

In 1986 and the first part of 1987, Mr. Thalasinos said, he had been buying mortgage-backed securities with returns generally between 130 and 150 basis points over comparable Treasury securities.

"All through 1988 we started liquidating (mortgage-backed securities) because the spreads had narrowed to about 75 basis points," Mr. Thalasinos said. The spread has begun to widen again, so he is beginning to "nibble" at them once more.

Because of the rapid rise in short-term interest rates, creating an inverted yield curve, the spread between some mortgage-backed securities and Treasuries reached zero to a "minus number in some cases," said Larry Diamond, a partner with Kenneth Leventhal in Los Angeles.

Top 200 funds with defined benefit assets invested in:

Mortgage-backed securities

Fund	Assets $ millions
California Public Employees	8,200
Ohio Public Employees	5,882
New York City	5,580
Texas Teachers	3,080
California State Teachers	2,590
New Jersey Investment	2,569
New York State & Local	2,567
Ohio State Teachers	1,571
Florida State Board	1,400
North Carolina Systems	1,325
Colorado Public Employees	927
Pennsylvania Public School	874
New York State Teachers	862
State of Michigan	843
Texas Employees	688
E.I. du Pont de Nemours	666
Bethlehem Steel	550
Washington State Board	544
Alabama Systems	516
Ohio School Employees	489
NYNEX	450
Tennessee Consolidated	443
Iowa Public Employees	418
Kentucky Retirement	406
Wisconsin Investment Board	378
Ohio Police & Firemen	306
Mass. Teachers & Employees	300
Louisiana Teachers	270
Los Angeles County	264
Ford Motor	250
Pennsylvania State Employes	243
Indiana Public Employees	221
Nevada Public Employees	219
American Airlines	200
San Francisco Employees	200
UMWA	200
USX	200
Arkansas Teachers	175
Shell Oil	175
Kentucky Teachers	166
Grumman	150
State of Delaware	141
Atlantic Richfield	140
New Mexico Educational	140
Oregon Public Employes	140
Los Angeles Water & Power	136
Commonwealth Edison	135
Armco	133
Louisiana State	120
General Dynamics	115
Detroit Systems	114
Exxon	114
Mobil Oil	107
Illinois Municipal	100
Milwaukee City Employes	80
Utah State	80
Aluminum Co. of America	75
Chicago Municipal	75
Hospital & Healthcare Workers	70
Inland Steel Industries	68
Nat'l Electrical Contractors/IBEW	68
Southern California Edison	68
Kansas Public Employees	51
Minnesota Mining & Mfg.	50
Delta Air Lines	50
Tenneco	50
Chevron	44
Owens-Illinois	36
United Methodist Church	24
Army & Air Force Exchange	23
Eli Lilly	17
Int'l Operating Engineers	16
University of California	14
Hawaii State Employees	7
Nat'l Rural Electric Co-op	5
S. New England Telephone	5
International Paper	4
Philadelphia Municipal	3
Total	49,955

Labor wins again

Accord reached on below-market loans

By Joel Chernoff

MANCHESTER, N.H. — Two New England union pension funds have settled Department of Labor charges that they invested in below-market certificates of deposit to finance a union-only construction project.

Trustees of the two funds, the Northern New England Carpenters Pension Fund and the Plumbers and Steamfitters Local Union 131 Pension Plan, agreed to reimburse the funds for losses and to hire outside investment advisers. Both funds are based in Manchester, N.H.

The latest settlements represent another victory for the department's policy that pension funds cannot accept below-market terms even if the investment creates jobs for union members.

James M. Dawson, president of James M. Dawson Associates Inc., the plan administrator for both plans, denied the funds did anything wrong, saying trustees found it was less expensive to settle the litigation than to battle the Labor Department. Mr. Dawson said he is a past chairman of the Society of Professional Benefit Administrators, a trade group.

For the $15 million Carpenters plan, it was the second case brought by the Labor Department for allegedly financing below-market construction loans. In August 1986, the trustees agreed to reimburse the plan $220,000 for allegedly making four below-market rate loans to aid construction of a local church with union labor (*Pensions & Investment Age*, Sept. 15, 1986).

The most recent settlement imposed tougher terms on the Carpenters trustees, requiring them to retain an investment manager for at least 10 years with sole responsibility for managing the plan's assets.

The trustees and Mr. Dawson also are required to repay $62,500 to the fund under the consent order, which was entered Jan. 26 in the U.S. District Court for the District of New Hampshire in Manchester.

The trustees are Robert Morin, Robert K. Morine Jr., Theodore J. Buczek, Richard Renaud, David Jones, John G. Willard and Robert Christy.

The Carpenters fund trustees allegedly channeled half of the financing for a $3 million construction loan through the New Hampshire Savings Bank, with the $12 million Plumbers fund providing the other half.

According to the government, the Carpenters and Plumbers funds on March 15, 1984, purchased $1.5 million each of three-year CDs from New Hampshire Savings yielding 9%.

While the Labor Department complaint does not specify what the yield should have been, Mr. Dawson said the government had argued an 11% yield was appropriate.

The bank then provided financing for the construction of the five-story office building. Under the terms of the construction loan, the plans were required to maintain their investment with the bank for the duration of construction, and only union labor was to be used on the project, the Labor Department alleged.

The department also alleged that Mr. Morine violated his fiduciary responsibilities by allowing the investment to benefit his employer, Harvey Construction Co., which had been pre-selected to perform work on the project.

Similarly, the department had charged Plumbers plan trustees John Doherty Jr. and Raymond Sarosy violated conflict-of-interests rules because the investment benefited their employer, Northern Peabody Co. Inc. The other Plumbers plan trustees charged by the government were Dana French, Robert Drew, Ronald Clair, Alan Gray, Mary Boudette, Ronald Boisclari and Russell Bell.

The Plumbers plan trustees also allegedly invested $1.2 million in a second below-market rate loan to rehabilitate a building with union labor. Under the court order, which was entered in U.S. District Court in Concord, N.H., Jan. 6, the trustees were required to repay $107,000 to the plan.

Mr. Dawson, the administrator, was barred from exercising investment authority over any ERISA plan by the order in the Plumbers case.

Criticizing the department's position, Mr. Dawson said Carpenter plan assets managed by Oppenheimer Capital Corp. have achieved a return of only 7.8% for calendar year 1988, compared with the 9% yield on the CDs. The Plumbers fund also is managed by Oppenheimer.

What's more, he said, the funds had contacted three area banks in arranging the CDs, and all of them had offered the same rate. ■

Revenue options told

By Joel Chernoff

WASHINGTON — Slashing the amount employers are allowed to contribute to pension and profit-sharing plans would raise $14.5 billion in tax revenue during the next five years, the Congressional Budget Office said in a new report on budget options.

In addition, imposing a 5% tax on realized investment income of retirement plans would raise $29.4 billion between 1990 and 1994, the report said.

The annual report, "Reducing the Deficit: Spending and Revenue Options," contains a laundry list of items for Congress to explore. Many suggestions appear year after year, but are not taken up because they are politically unpalatable. Their presence on the list, however, ensures the ideas will receive some attention by legislators.

Employer representatives are worried, however, that Congress will take aim at the Section 415 limits, which restrict the amount employers can contribute to retirement plans, as a means to cut the budget deficit. Congress has trimmed the 415 limits previously as a way to raise revenue.

"What's making the whole employee benefits area so vulnerable is that benefits provide the opportunity to raise revenue without appearing to the public that taxes are being raised," said Jim Klein, deputy executive director of the Association of Private Pension and Welfare Plans, Washington.

The CBO, the budget-policy research arm of Congress, estimates that for 1990, contributions to defined benefit plans will be limited to the amount that will yield an annual pension of $103,100 at age 65, while contributions to defined contribution plans will be restricted to $30,000 per employee. A combined limit of $128,900 would apply to employees eligible for benefits from both kinds of plans.

"These funding limits are far higher than the pre-retirement earnings of most workers," the CBO report said. "Only one half of 1% of employees earn more than $128,900 a year."

Dropping the funding limits for defined benefit plans to the Social Security wage base (projected to be $50,700 in 1990), and the defined contribution limit to $14,800, and indexing the limits to inflation thereafter, would raise about $14.5 billion from 1990 through 1994, according to the CBO study.

"The principal argument against reducing funding limits is that it would make participation less attractive to high-income business owners and top managers, and thus might discourage them from sponsoring these plans both for themselves and for their employees," the study added.

But Mr. Klein said the CBO is missing the point that reducing 415 limits hinders employers' ability to pre-fund benefits even for moderate-income employees. Employers need to pre-fund on the basis of projected salaries, he said.

In other options, the CBO suggested:

- Reducing the maximum annual employee deferral to a 401(k) salary reduction plan to $4,000 from an estimated $8,800 for 1990 would save $2.4 billion during the next five years. That would retain full incentives for middle-income employees to save, but the CBO notes some argue it would be better to wait to evaluate the impact of new non-discrimination rules on employee deferrals to 401(k) plans.
- Imposing a 5% tax on realized investment income earned by pension funds and individual retirement accounts, which would raise $29.4 billion between 1990 and 1994.

Taxing realized investment income of such plans would reduce "the inequality of taxation between the higher-paid and the longer-term employees who gain the most from the current tax treatment, and the lower-paid and mobile workers who gain the least," the study said.

But taxation of investment income also could lower retirement income or raise costs, discourage use of such plans, and even cause greater disparities in retirement income, the study said.

Imposing a 5% tax also would cause pension funds to take a longer-term orientation, making it an attractive option in the current debate over mergers and leveraged buy-outs.

- Taxing other fringe benefits, such as some health insurance premiums and life insurance premiums or imposing a 3% excise tax on the value of non-retirement fringes also could generate significant revenue.
- Taxing Social Security and Railroad Retirement benefits could generate between $5.2 billion and $97.2 billion during the next five years, depending on how much of the benefits were subjected to taxation. ■

Borders hazy

Continued from page 3

cisions based on signals of market direction, such as liquidity, price momentum or market sentiment, while other allocators put more emphasis on the relative value of each asset class, Mr. Kingsland said.

Yet many firms use a blend of the two approaches.

Classic tactical asset allocators, Mr. Kingsland said, include Wells Fargo Investment Advisors and Mellon Capital Management, two San Francisco firms that take a long-term, value-driven approach, and First Chicago Investment Advisors, with an even longer-term, value-driven outlook.

Avatar Associates, New York, might be called a timer or a more active tactical asset allocator, as its model is driven mainly by liquidity, he said.

Bruce Poliquin, vice president and director of client servicing at Avatar, now rejects the timer label, although he referred to Avatar as market timers in the past. "We are measuring relative valuation, but we are not using a dividend discount model," as do many value-driven approaches, said Mr. Poliquin. "When liquidity is drying up, the value of stocks is outweighed by the value of cash reserves."

Some observers press the case that all investment management is timing.

"I for one don't take umbrage at the label 'market timer,' said Robert D. Arnott, president of First Quadrant Corp., Pasadena, Calif., who uses both value and signal indicators. No matter what factors a manager uses, the nature of the process is timing, he said.

"Everybody's a timer, whether he believes it or not," said James H. Ayres, president of J.H. Ayres & Co. Inc., Colorado Springs, Colo., and an acknowledged market timer. J.H. Ayres moves between equities and cash. Even the decision to buy or sell an individual security is a timing decision, Mr. Ayres said.

Tom Monroe, assistant vice president of Frank Russell Co., Tacoma, Wash, sees true allocators as those who follow their models strictly; when the managers overlay their models with personal judgments and allocate among more than just stocks and cash, they become what he calls "asset class timers." He declined to name firms that would fit into that category. But according to *Pensions & Investment Age* research, firms that fit this designation include M.D. Sass Investor Services Inc., New York; Prudential Diversified Investment Strategies, Newark, N.J.; Chase Investors Management Corp., New York; and Northern Investment Management Co., Chicago.

Officials at these firms said their models give them a range or guideline on asset mix, and they supplement that with judgment.

NCNB Texas National Bank, Dallas, also uses a tactical model to help manage balanced accounts. NCNB Texas portfolio managers, however, put their judgment into setting the normal mix for each portfolio, then shift that mix based on the model's recommendations, without adding further judgment, said John Meneghetti, manager of quantitative services.

Almost all the executives interviewed by *P&I Age* use quantitative tools to some extent.

Whether models involve forecasting, however, is a point of contention; most managers say their decisions depend on current, readily available information, not forecasts. This type of information, however, might have an implicit aspect of forecasting — it is valuable because it bodes well or ill for financial markets.

"I'd like to know who thinks they can do tactical asset allocation without forecasting," said Michael A. Petrino, president of Matrix Capital Management, Greenwich, Conn. "If tactical asset allocators are going to add value, they have to forecast."

"To say that we forecast is misleading," said Mike Schroer, director of research for Renaissance Investment Management Inc., Cincinnati. "It's a very fact-based methodology."

Many managers do acknowledge implicit forecasting. "If our valuation indicators are tremendously one-sided, if they're saying the markets are very overvalued, the trend is more likely to be down than up," said Steven Lauer, manager of the options and futures group at Bankers Trust Co. — Investment Management Group, New York.

Generally, firms practicing allocation or timing gradually move between the two extremes of 0% to 100% in a given asset class.

A standard move for Bankers Trust's tactical asset allocation accounts is 5%. On Oct. 20, 1987, it made about a 30% move into stocks, with most of the money coming from cash, but "that's a once-in-my-lifetime experience," Mr. Lauer said.

Firms that typically make big moves — 50% to 100% at once — include J.H. Ayres; Schield Management Co., Denver; Renaissance; Hoisington Investment Management Co., Houston; and Consistent Asset Management Co., Wilmington, Del.

The firms that make the biggest moves tend to do so less frequently. J.H. Ayres has made only two moves in the past five years, and Hoisington, just two in the past six. Renaissance's moves average every eight to nine months, although sometimes it will hold an allocation for just four to six weeks and other times for more than a year. Schield has averaged 2.5 moves a year in the 17 years it has been in business.

Consistent has made 24 moves in the two years it has been in business, but its moves are smaller.

Most allocators and timers use a mix of domestic stocks, bonds and cash. Others have stock/cash and bond/cash strategies in addition to the three-way allocation; some known mainly for stock/cash strategies, such as Avatar and Schield, recently added three-way strategies.

A few add international securities, real estate and even venture capital to the mix. Gary Brinson, chief investment officer of First Chicago, noted it's hard to move money in and out of illiquid investments like real estate and venture capital, so these serve more as places to put extra cash flow.

Some managers implement tactical asset allocation for a minority of their accounts strictly with an overlay of derivative securities. These include Wells Fargo; Mellon Capital; The Boston Co. Inc., Boston; J.P. Morgan Investment Management Inc., New York; Avatar; and First Quadrant.

J.H. Ayres doesn't use overlays because the firm makes its equity investments through large, liquid mutual fund groups. Hoisington doesn't use them because Treasury securities are so liquid.

Most of the managers function for at least some clients as "swing" managers — shifting a client's entire asset mix, even though they manage only a portion of the fund. Webster Capital Management, New York, sees itself as more a "return enhancer" than a swing manager, while some Boston Co. clients use the firm's tactical strategy for aggressive balanced management. ■

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Various styles mark investors in ailing firms

Here are brief sketches on several key firms that invest in distressed companies.

• **Neuberger and Berman**, New York, expects to raise $250 million from individual and institutional investors for its first fund targeting troubled companies. The firm has been making bankruptcy investments for its own account for eight years. The fund will buy bank loans and other creditor positions with fund managers taking an active role in reorganizations.

• **Calhoun, Meehan & Co. Inc.**, Boston, soon will close a $10 million to $15 million fund. The lead investor is Weiss, Peck & Greer's buy-out fund, CDA III. The Calhoun, Meehan fund will be marketed mainly to high-net-worth individuals. The "revitalization fund" buys companies with between $25 million and $250 million in sales and strong middle management teams with high variable margin and high fixed costs.

• **Oppenheimer & Co. Inc.**, New York, has invested its own capital in bankruptcies for more than 10 years, but started its first fund for clients in September 1987. It recently launched an equivalent fund for foreign investors. The firm has $145 million invested in distressed companies, and expects to raise another $100 million from institutions over the next 12 months. Investments are diversified, generally in larger deals; no more than 3% to 4% is invested in the outstanding securities of any one company.

• **Trust Co. of the West**, Los Angeles, just reached its goal of raising $100 million in a limited partnership from institutional investors. TCW, which invests along with its limited partners, likes to buy secured or senior debt instruments. TCW focuses on a few large, well-known companies, often which are still profitable, that it is confident will emerge from bankruptcy.

• **T. Rowe Price Associates Inc.**, Baltimore, raised $107 million, mostly from institutional investors, for its Recovery Fund L.P. The limited partnership will invest primarily in the debt securities and liabilities of companies experiencing significant financial difficulty.

• **The Foothill Group Inc.**, Los Angeles, expects to raise about $30 million from institutions for its second fund. John Nickoll, president and chief executive officer, said the firm, which has about $100 million in another fund and its own capital invested in this area, invests in companies in bankruptcy or in some stage of restructuring and prefers senior unsecured debt.

• **Pacholder Associates**, a Cincinnati firm that manages almost $2 billion in high-yield assets mainly for institutions, has about $100 million invested mostly in debt securities of troubled companies. The firm has not raised any new money lately. President Al Pacholder said his firm maintains a diversified portfolio of 25 to 30 companies.

• **Morgens, Waterfall, Vintiadis & Co. Inc.**, New York, runs $100 million in distressed securities for individuals and foreign institutions. The firm has a fund that will close soon called Restart Partners L.P., which aims to raise $250 million from institutions and individuals. The firm has a 10-year compound annualized return of 21.7%. The firm invests passively through a diversified portfolio with the aim of rebuilding rather than liquidating businesses.

• **Whitman Heffernan Rhein & Co. Inc.**, New York, has been in the bankruptcy business since 1974 when it was investment bank M.J. Whitman & Co. Inc. It has been an independent firm since April 1987. The firm soon will close the $30 million Whitman Heffernan Rhein Workout Fund L.P. Within three months there will be a second closing, during which an additional $20 million to $30 million will be raised and pension funds will be targeted for some of the capital.

• **Magten Asset Management Corp.**, New York, manages $650 million, of which less than half is invested in bankruptcies and near-defaults. The firm buys stock, bonds and paid-in-kind preferred stock and has been in the bankruptcy investing business since 1978. The firm offers no limited partnership funds but was hired to manage a partnership for a bank trust department the firm would not identify. Most investors in the separate accounts are U.S. tax-exempt institutions.

• **Recovery Equity Investors**, San Francisco, is organizing a fund called Recovery Equity Partners L.P., which will raise $100 million to $150 million for equity-oriented investments and participation in management of bankrupt companies. The fund will target only institutional investors.

• **Halcyon Investments**, New York, launched its first fund, the Halcyon Distressed Securities fund, in January and raised $25 million. The investors were mostly wealthy individuals. The fund mainly invests in public securities of bankrupt companies. ■

Windfall not idle

Continued from page 2

takeover targets, he said.

Mr. Janecek said he thinks the Federal Reserve Board's recent ruling that companies with debt-to-equity ratios of one-third or higher that engage in leveraged buy-outs be considered "highly leveraged" — and therefore risky enough to require high-interest loans — will crimp merger and acquisition activity, but not significantly.

"There seems to be no shortage of deals to go into right now," he said. Although he cited **Texas Eastern Corp.**, **Burlington Resources** and **Pennwalt Corp.** as examples, he would not say if the Florida fund had acquired positions in those firms.

The Kentucky Teachers' Retirement System, Frankfort, sold its 310,000-share RJR Nabisco position prior to redemption, and put the money into Treasury-based repurchase agreements and then rolled some of the overall profits into **Exxon Corp.**, **General Motors Corp.** and **Wal-Mart Stores Inc.**, companies in which it had previous holdings. The balance, according to Stuart A. Regan, the fund's investment officer, is still in repos and 5-year Treasuries, with most of it earmarked for the bond market. ■

Bankruptcy

Continued from page 1

One of the newest firms to enter the bankruptcy arena is Amroc Investments L.P., started by Philip G. Schaeffer and Marc Lasry, who started the bankruptcy investment department of Cowen & Co., Boston, in January 1987. Amroc Investments plans to raise $60 million to be invested mainly through private debt vehicles.

Other firms marketing funds include Morgens, Waterfall, Vintiadis & Co. Inc., New York; Recovery Equity Investors, San Francisco; and Halcyon Investments, New York.

The leaders in raising institutional capital for bankruptcy investments thus far have been investment banks, commercial banks and finance companies. They include: Whitman Heffernan Rhein & Co. Inc., a private investment bank in New York; Oppenheimer, the New York brokerage house; The Foothill Group, a Los Angeles commercial finance and asset-based lending institution; Trust Co. of the West, Los Angeles; and R.D. Smith & Co. Inc., a New York brokerage firm specializing in the trading of securities of companies in financial trouble.

Limited partnerships investing in troubled companies have begun to pique the interest of a growing number of institutional investors looking for high returns amid a broadening array of corporate finance-related investments.

Another propellant has been the erosion of the stigma associated with bankrupt companies, in large part because many profitable companies like Manville Corp. and Texaco Inc. sought the protection of bankruptcy court for reasons other than financial ailments.

Leveraged buy-outs expected to fail in the event of a recession will be a source of diverse, quality investment opportunities, bankruptcy fund managers say.

"LBO companies in trouble usually don't need an operating turnaround, they just need to shrink debt. Chapter 11 is good for that," said James Heffernan, managing director of Whitman Heffernan.

Despite growing investor enthusiasm, those who have marketed funds recently admit it isn't easy to raise money for these partnerships, in part because the stigma isn't entirely gone.

Another obstacle is the fact many states bar public pension funds from investing in the securities of bankrupt companies. In addition, corporate pension executives are unsure how much, and in what vehicles, they may invest in defaulted bonds under the Employee Retirement Income Security Act.

Institutional investors compare their interest in distressed company limited partnership funds to the pioneering leveraged buy-out pools assembled several years ago. Many cutting-edge institutions invested in these pools to capture what were then extremely sizable returns.

The $1 billion Warner-Lambert pension fund has committed $10 million to T. Rowe Price Associates' $100 million fund, the pension plan's first bankruptcy investment. Warner-Lambert executives liked the fact the fund invests mainly in private debt, which promises better returns, Mr. Shapiro said. The plan expects to earn about 30% annually.

Bankruptcy securities also offer investors a good source of diversification. "This type of investment is to a large degree market independent," said Jeffrey Stern, managing director of Oppenheimer, explaining the performance of bankrupt companies isn't correlated to stock market movements.

He added there's room for ample returns, as there was more than $5 billion in defaulted bonds in 1988, far exceeding the amount available for investment in the area.

Many institutional investors, however, are worried the field already is getting crowded, a complaint heard many times with respect to leveraged buy-out pools.

Consultants and other experts said it will be a good test of the market to see whether the funds now raising money from institutions will reach their goals. Many believe the lofty returns associated with early troubled-company funds — ranging from a low of 20% to as much as 300% on "home runs" — will fall in the not too distant future, as they did with leveraged buy-out funds.

"There's a lot of money finding itself into the arena," said Jack Meyer, treasurer and chief investment officer of The Rockefeller Foundation, which has $10 million invested with Oppenheimer. "We suspect we won't make any new allocations."

Styles of bankruptcy investing range from the diversified portfolio approaches of firms like Oppenheimer and T. Rowe Price to more concentrated investments like Whitman Heffernan Rhein, to turnaround or recovery investors like Calhoun, Meehan & Co. Inc., Boston, which acquires troubled companies.

The firms buy everything from public debt and equity securities to private bank debt. Some limit their investments to only senior secured securities; others don't mind buying subordinated debt. ■

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Economist sees peril in debt levels

NEW YORK — Add another voice to the chorus of economists, lawmakers and others sounding alarms about the leveraging of corporate balance sheets.

In a newsletter, Robert Schwartz, vice president-senior financial economist at Merrill Lynch Capital Markets, said the market was skewed by the rash of acquisition-related debt financing in 1988. He noted that through the first three quarters of 1988, net redemptions of non-financial corporate equity soared to a record $109 billion annual rate, adding to the $313 billion of stock liquidations that occurred from 1984 through 1987. But during the same time frame, corporations added $750 billion of new debt.

"Statistically these numbers suggest that acquisition activity has been responsible for about 50% of new corporate debt creation since 1984. Moreover, the data do not capture the megadeals announced in the fourth quarter, including the $25 billion RJR Nabisco Inc. leveraged buy-out, which should shatter previous quarterly records," he said in his newsletter.

Mr. Schwartz said the huge influence of acquisition activity has led to a growing discrepancy between the financing needs generated from operations and actual borrowing by corporations.

The ratio of credit market borrowing to capital spending by non-financial corporations has jumped to an average of 46% during the past five years from 26% in the 1975-'83 period. The growing mountain of acquisition-related debt is boosting operating expenses by generating higher interest payments. In the third quarter, the $114 billion of net interest payments accounted for 25% of cash flow, Mr. Schwartz said, a record for a non-recessionary period and up from 18.5% in mid-1985.

These payments coupled with rising unit labor costs have started to crimp cash flow, resulting in a widening gap between capital spending and internally generated sources of funds, according to the economist. The financing gap of non-financial corporations jumped to a $53.5 billion annual rate in the third quarter, nearly 50% above the first quarter level. He predicted the gap should continue to widen during the next several quarters.

Mr. Schwartz expects the funding requirements associated with acquisitions and leveraged buy-outs, together with the widening financing gap, to lift corporate borrowing requirements during the next several months. These requirements will be satisfied mostly in the short-term markets, Mr. Schwartz said.

The bias toward short-term financing together with the markets' reaction to an actual and expected firming of monetary policy have contributed to a dramatic flattening of the yield curve in recent months. The prospective mix in the demand for funds indicates the curve will remain flat through the early months of 1989. He looks for issuance in the bond market to pick up as 1989 unfolds, assuming the market environment is receptive.

Ultimately, Mr. Schwartz said, the ability of corporations to successfully tap the bond market will depend on the prospective supply of funds available to issuers. He cited several trends supporting a pickup in issuance in 1989.

He noted foreign investors have returned to the corporate bond market. Reflecting a pickup in Eurodollar financing by U.S. corporations, foreign investors absorbed 18% of net bond issuance in the third quarter, up substantially from the 12% share in 1987 and nearly as much as the 20% share in 1986. Although the dollar will probably will weaken further next year, foreign investors should be attracted to the higher interest rates on U.S. securities relative to those on other currencies and continue to favor fixed-income markets over equities in the United States.

He said U.S. investors also continue to show a preference for fixed-income securities. Both private pension funds and mutual funds are channeling all new investment flows to the credit markets while liquidating equities, Mr. Schwartz said. The dominant player in the corporate bond market — life insurance companies — are experiencing a surge in inflows owing to the booming demand for guaranteed investment contracts associated with the growth in defined contribution plans as well as for annuities to satisfy pension obligations left unfunded by defined benefit plan terminations. ■

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buy new S&P stocks soon after the S&P announcement.

Of State Street's $11 billion in passive domestic equities, approximately $8 billion is in S&P index funds.

The period from Jan. 31, 1984, to Oct. 31, 1988, was selected for PaineWebber's study because that was when the supply of equity began to shrink at an unprecedented rate.

The heavy turnover has increased return on equity of the S&P by about 79 basis points because smaller, less profitable companies were the most affected by the restructuring wave.

Small-capitalization stocks in the 1984 S&P 500 were more likely to disappear than larger ones; about half of the smallest stocks have disappeared.

Larger companies were relatively unaffected. The top 15 companies accounted for 25% of the S&P market capitalization and escaped the restructuring trend unscathed. The top 50 S&P companies accounted for 46% of the index's value, and six companies disappeared.

The companies that disappeared tended to have below-average returns on equity; 45% of the disappearing companies had ROEs of less than 10% while only 8% had ROEs in excess of 20%. Of the companies that replaced the dropouts, 32% had ROEs greater than 20%.

"In the last year, the changes I've seen (in the S&P) have definitely been (toward) growth-oriented stocks," said Jeanne Valcik, associate investment officer of the $3.2 billion Illinois State Universities Retirement System, Champaign, which invests about 25% of its assets in a Wilshire 5000 index fund.

Among all industries, 14.1% of the market value of the S&P was lost during the five-year period. Eighty-eight companies disappeared because of mergers and acquisitions, 36 because of leveraged buy-outs and 13 because of Chapter 11 proceedings or severe financial difficulties.

The representation of several industries was sliced during the period. The hardest hit was the housing and building materials industry, which lost 34.2% of the market value in the sector. In addition, 27.9% of the market value of the energy sector and 27% of the market value of the consumer non-durable sector disappeared.

Companies in these sectors that disappeared include **American Standard Inc., Jim Walter Corp., Gulf, Chesebrough-Pond's Inc., Revlon Inc., General Foods Corp., Kraft Inc., Pillsbury Co., Nabisco Brands Inc., Allied Stores Corp., R.H. Macy & Co. Inc., Levi Strauss & Co.** and **Burlington Industries Inc.**

(Although Standard & Poor's Corp. once adhered to certain guidelines in allocating companies by sector, the firm now has floating sector weightings.)

Replacement companies are midsize growth companies in the health, technology and finance sectors. In addition to higher ROEs, the companies typically are smaller than the typical S&P 500 company. Of the replacement companies, 58% had market caps of less than $1.5 billion, vs. 38% for all companies in the S&P 500 in 1988.

Among the replacement companies are **Rubbermaid Inc., Albertson's Inc., The Home Depot Inc., Medtronic Inc., Air Products and Chemicals Inc., Great Northern Nekoosa Corp.** and **Cray Research Inc.** ■

The disappearance of small-cap stocks

Market cap ($ millions)	%
10-249	52.6
250-499	40
500-999	29.7
1,000-1,499	20
1,500-1,999	15.5
2,000-2,999	20.4
3,000-4,999	5.1
5,000 plus	14

Percentage of stocks that disappeared between January 1984 and November 1988 by market capitalization.
Source: PaineWebber, New York

Axe-Houghton evolves as fixed-income firm

TARRYTOWN, N.Y. — Axe-Houghton Management Inc., long known as a growth stock manager, is emerging as a significant manager of fixed-income assets.

Fixed-income assets under management by the firm have climbed to about $1.5 billion from about $100 million in early 1986.

Of the current total, $268 million is for tax-exempt clients, with the remainder coming from USF&G Corp., Axe-Houghton's parent, and its insurance subsidiaries. Most of the USF&G assets were phased in over the latter part of 1988.

In the year ended Jan. 31, Axe-Houghton has picked up a $100 million fixed-income account from the City & County of San Francisco Employees Retirement System; a $30 million fixed income account from the Kern County Employees Retirement System, Bakersfield, Calif.; and $30 million fixed income from Local 814 of the Teamsters Union, Long Island City, N.Y.

The USF&G accounts have given Axe-Houghton's fixed-income investment operation a critical mass it might otherwise have taken years to achieve, despite excellent investment returns.

Axe-Houghton's fixed-income investment efforts were an adjunct to the equity management efforts and existed so the company could offer balanced accounts, said Robert E. Manning, director of fixed-income investments. But the company's long-term fixed-income record was too good to ignore, he said.

For the five- and 10-year periods ended Sept. 30, the firm's composite fixed-income results placed it in the top 1% of the SEI Funds Evaluation universe, with respective returns of 16.3% and 13.5%. For shorter periods, the 1987 calendar year return of 0.6% placed the firm just below the SEI median of 1.4%. In 1988, the company was in the SEI 15th percentile with a return of 14.4%, compared with 13.4% for the Salomon Brothers Broad Investment Grade Index. For the one- and five-year periods ended Dec. 31, the Salomon BIG Index returned 0.2% and 12.7% respectively.

According to Mr. Manning, Axe-Houghton's fixed-income style is a "high-quality corporate" approach. "We like to employ the corporate side because we think that if you use corporate bonds in a portfolio you can get around a 60- or 70-basis-point return for being exposed to corporate risk," he said.

"We are typically long-bond managers as well. We try to manage so the duration of the portfolios is one or two times that of the bond indexes."

Now, the portfolios are shorter than the Salomon BIG Index and have a higher proportion of government and agency securities than is normal.

"What we try to stress in the portfolio in general is credit and quality spreads."

Mr. Manning said the portfolios were positioned conservatively, and he did not expect to be able to call the turn in interest rates. ■

GEIC selects State Street as sole custodian

STAMFORD, Conn. — General Electric Investment Corp. has consolidated its custodial arrangements by dropping Chase Manhattan Bank and the Bank of New York and hiring State Street Bank and Trust Co., Boston.

State Street will be the domestic and global custodian and handle all back-office services related to the daily management of GEIC's more than $30 billion in investments.

GEIC is responsible for General Electric Co.'s pension and other employee assets. A GEIC spokesman said GEIC switched to save money and because of the "technological and globalization advancements made by State Street in security movement and control systems."

For State Street, with more than $625 billion in assets under custody, the new arrangement represents the first time a corporate client "has taken us up on using all our services in an integrated way," said Ron Golz, executive vice president at State Street.

To help handle the new business, State Street is establishing a special administrative unit at its Quincy, Mass., location. The unit will provide custody and consolidated accounting and reporting services.

Prior to the arrangement, the GEIC staff was responsible for its own investment accounting, and used Chase Manhattan as custodian for pension fund assets and the Bank of New York as custodian for most mutual fund assets. State Street has been custodian for one GEIC mutual fund and investment manager for one international index fund.

Also, State Street announced the Pension Benefit Guaranty Corp. renewed its contract for benefit payment services. State Street performed the service for about two years, and won the five-year renewal in competitive bidding. ■